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SUBJECT: HONG KONG ECONOMISTS HIGHLIGHT CHINA'S ECONOMIC IMBALANCES, PRAISE NEW FINANCIAL LINKS WITH THE MAINLAND

SUMMARY

¶1. (SBU) Comments from Hong Kong-based economists made in a series of meetings with visiting Beijing Finance Attache and Econoff suggest the following: Chinese economic policy makers understand the negative byproducts of the current macroeconomic policy mix: including overcapacity in some industries, a structurally high trade surplus, excessive foreign exchange reserves, excessive growth in monetary aggregates, and asset price inflation. However, some parts of the Chinese Government, e.g., the National Development Reform Commission (NDRC), remain sensitive about slowing investment growth and encouraging consumption in its place because they fear any transitional slowdown could adversely impact the rural and migrant populations, exacerbating social tensions. A more rapid pace of renminbi (RMB) appreciation is a powerful tool in reducing high levels of liquidity and there are signs that several economic ministries are growing more comfortable with this prospect. China is likely to start investing its rapidly accumulating foreign exchange reserves in higher-return assets, particularly equities traded in large and liquid stock exchanges, including the listed shares of companies based in emerging markets.

¶2. (SBU) A recent announcement that mainland financial institutions will be able to issue renminbi-denominated bonds in Hong Kong breaks new ground: this is the first time that renminbi-denominated financial instruments will be issued outside of mainland's financial system. However, the near-term prospects for issuing RMB bonds in Hong Kong are modest, as the pool of RMB deposits remains small. The Hong Kong Monetary Authority (HKMA) hopes that giving Hong Kong-based banks higher yielding RMB fixed income assets will allow them to offer higher deposit rates and thus increase RMB deposits over time. HKMA also hopes the bonds will be a source of financing for foreign bank subsidiaries in China that may find it convenient to draw on renminbi deposits in Hong Kong (since it will be initially difficult for these entities to collect renminbi deposits on the mainland itself). However, Beijing-based regulators say they do not plan to allow foreign banks to issue RMB bonds in Hong Kong in the near-term. END SUMMARY

MEETINGS IN HONG KONG

¶3. (U) Beijing-based Financial Attache and Econ Internal Unit Chief joined Congen Hong Kong's Economic Unit Chief

for a series of meetings with Hong Kong-based economists and the Hong Kong Monetary Authority. The meetings were held in late January, 2007.

A NEED TO REBALANCE

¶4. (SBU) All of the Hong Kong-based economists said that China's investment- and export-led growth model is unsustainable, and several of them assessed that PRC economic policy makers across all ministries now increasingly understand this. However, Citibank Managing Director Yiping Huang, for example, characterized the NDRC as particularly anxious about slowing growth, given the priority placed on job creation, but asserted that even these officials increasingly understand that greater consumption can offset over time any decline in growth due to lower growth in investment and net exports. However, the social welfare spending needed to achieve this (to fund pensions, health care, and education) is less visible to the population than tangible fixed asset investment activity like building bridges and thus less politically attractive to local government officials. Huang predicted that government officials will remain hesitant to meddle in an economy still experiencing high growth and manageable inflation, and China will likely stay the current course until forced into change by an economic shock.

¶5. (SBU) Deutsche Bank Managing Director Jun Ma expressed concern that measures taken to date to slow down investment are insufficient. He is already seeing data that suggests that the growth rate in fixed asset investment, which has cooled in recent months, is on the way back up, as local governments simply delayed implementation of projects into 2007 to meet administrative targets. Large capital inflows

are inflating asset prices; there may already be a bubble in the stock market and a continued need to take measures to cool the property market. He envisaged the recent downturn in the Chinese and Hong Kong stock markets and he also said another small interest rate increase would help signal that the government has assessed that asset inflation has gone too far. John Anderson from UBS thought that the sharp rise in the Chinese stock markets was not in the Chinese government's interest. If valuations got too high, regulators might need to reimpose the moratorium on IPOs to reduce supply, which would undermine their efforts to improve corporate governance through IPOs. From the regulators' perspective a steadily, but not excessively, rising stock market was ideal.

CURRENCY AND RESERVE POLICY

¶6. (SBU) Several economists to whom we spoke predicted that China will soon put aside US$ 200-300 billion of its 1 trillion in foreign exchange reserves to invest in higher yielding assets, particularly equities in large and liquid financial markets. Most thought the PRC would take great care not to destabilize markets. One economist thought there would be a bias against U.S. stocks because of concerns about dollar weakness. This economist expects China to consider emerging market stocks that trade in liquid markets (such as American Deposit Receipts of such companies). The underlying fundamentals of these securities reflect the home country economies, which should outperform in the coming years, enough so to make up for U.S. dollar weakness.

¶7. (SBU) An economist said his discussions with People's Bank of China (PBOC) officials convinced him they are looking for evidence to convince skeptics that currency appreciation will help pressure Chinese companies to move up the value-added chain, thus helping to support a key Chinese government priority. He characterized the Ministry

of Commerce (MOFCOM) as relaxing its resistance to currency appreciation, having observed that no significant harm has come to exporters since China broke its U.S.-dollar peg in July 2005. Another economist said that his PBOC contacts recently told him that the case for RMB flexibility is growing stronger but that arriving at broader government political consensus will take time.

RENMINBI BONDS IN HONG KONG

¶8. (SBU) China recently announced approval for the sale of renminbi-denominated bonds in Hong Kong by mainland financial institutions. This will widen the channels for renminbi deposits held by Hong Kong household and enterprises to flow back to the Mainland. The move is the latest step since the 2004 opening up of renminbi business in Hong Kong, where 38 banks have already taken nearly US$ 3 billion in RMB deposits and the use of mainland issued bank cards for purchases in Hong Kong by tourists is now widespread.

¶9. (SBU) Hong Kong Monetary Authority External Department Executive Director Julia Leung observed that RMB bond issuances will likely be limited as first, since only those residents and businesses allowed to maintain RMB deposits (earned though valid current account transactions) or banks using those deposits will be allowed to purchase RMB denominated bonds. However, since the bonds can be expected to offer higher yields than RMB deposits at the Bank of China, which is where Hong Kong based banks must now place their RMB deposits (which are subsequently deposited in the PBOC's Guangzhou branch), their effect is likely to be an increase in the interest rate on RMB-denominated bank deposits and a growth in such deposits over time. Leung assessed that foreign banks and corporations with a need for RMB in China may eventually be able to issue RMB bonds. This could, for example, be useful to foreign banks that seek a source of RMB to make loans in China, given that due to limited retail networks, it will take time for these banks to grow their RMB deposit base. (Comment: In subsequent meetings, PBOC officials said there is no plan to allow Chinese subsidiaries of foreign banks to issue RMB bonds in Hong Kong in the near term.)

CDR'S: A NEW CHANNEL FOR OUTFLOWS?

¶10. (SBU) One economist told us that China's State Administration for Foreign Exchange (SAFE) is undertaking research on creating Chinese Depository Receipts (CDRs) (Note: A CDR would be a locally issued and traded financial instrument with the underlying foreign stock shares held by mainland banks; the net effect would be local investors would have a vehicle, in addition to the Qualified Domestic Institutional Investor (QDII), for investing in foreign stocks. End Note). State-controlled media has speculated that CDRs would enable Hong Kong-based Red Chips (subsidiaries of Chinese state-owned enterprises that are listed in Hong Kong) to trade their shares in mainland China; these entities cannot list on mainland China's domestic stock exchanges because they are technically "foreign." The Hong Kong Government recently published recommendations from its in-house think tank, the Central Policy Unit, calling for the introduction of "depository certificates" of financial instruments issued in the HKSAR for trading on stock exchanges, interbank markets, or over the counter on the Mainland."

REACTION TO NEW FINANCIAL INSTRUMENTS

¶11. (SBU) Hang Seng Bank Deputy General Manager Andrew Fung underscored the importance of new links with the mainland's

financial system for Hong Kong's status as a financial center. He sees particular benefit to Hong Kong in CDRs, which he assessed to be "a done deal." Fung said that RMB bonds are a helpful pilot effort but observed that they will only be marketed through a limited channel - Hong Kong residents and banks that have RMB deposits. He noted that Hong Kong would also like to see RMB-denominated listings on its exchange, but to be liquid this would require a significant capital account opening that mainland China is not ready for. In the meantime, HKD-denominated H-share IPOs end up discounted because of anticipated depreciation relative to the RMB that takes place during the lengthy time required to convert Hong Kong dollar initial public offering proceeds to RMB.

¶12. (SBU) HKMA's Leung said that although the RMB bonds create new inflows into China, they are a key step forward in expanding Hong Kong's role as a financial center that can serve the mainland's financial system. If mainland China goes forward with CDRs, this will also be an opportunity for Hong Kong's financial sector while at the same time creating a new channel for capital outflows. Leung expressed interest in seeing an expansion of the QDII program noting that this would create fee income for financial institutions based in Hong Kong.

¶13. Leung noted that a high level advisory group had recently issued a series of recommendations for reforms of the mainland financial sector to promote Mainland/Hong Kong integration. She encouraged the USG to review these recommendations (which received considerable support, though not an explicit endorsement from the HK government) and considering incorporating them into SED deliverables so that mainland officials would hear a unified message on financial services liberalization.

SHENZHEN DEVELOPMENT BANK

¶14. FINATT met with Shenzhen Development Bank (SDB) President Frank Newman. Newman stressed the important and supportive role of Shenzhen city officials, who are appreciative that Newbridge had turned SDB from a large contingent liability into an income-earning asset. He viewed the arrest of the bank's former Party Secretary as a sign that the government and party are increasingly serious about reducing directed lending.

¶15. Newman expressed concern that despite numerous attempts, China's Securities Regulatory Commission (CSRC) would not approve Newbridge's proposal to compensate tradable shareholders, by allowing it to issue stock to meet capitalization requirements. He noted that large institutional holders of tradable shares understood Newbridge's prudential constraints on giving away financial assets to tradable shareholders. He thought it was unfair for CSRC to press Newbridge to provide the same amount of

compensation as non-tradable shareholders in other listed companies because typically those non-tradable shareholders (most often the government) owned a 70 percent stake, while tradable shareholders in SDB only owned an 18 percent stake. However, he thought CSRC was reluctant to approve any deals too different from others out of concern they would be criticized for approving a more favorable arrangements for foreign shareholders.

¶16. Newman said China's Banking Regulatory Commission (CBRC) and PBOC moral suasion and administrative controls tend to be implemented "pragmatically." He noted that though SDB was initially on the list of banks that were prohibited from providing new loans last summer, once they explained the progress SDB had made in improving their operations and how important new loans were to their reforms, regulators allowed them to go ahead.

¶17. Newman thought CBRC was comfortable maintaining the current foreign direct investment (FDI) limits in Chinese-invested banks (20% for a single investor and 25% for all foreign investors). It was large enough to allow for strategic investments, bringing capital and know-how, but still allowed the majority of financial benefits to accrue to domestic investors.

¶18. (SBU) This message was jointly drafted by Congen Hong Kong and Embassy Beijing.